Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:[redacted]:POSTF-126523-02
[redacted]

date: July 1, 2002

to: Examination Division, [redacted]
Attn.: [redacted], Team Coordinator
EXAM-[redacted]

from: [redacted]
Attorney (CC:LM:CTM:[redacted])

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subject: [redacted]; EIN: [redacted]
I.R.C. §338 election; foreign targets

This memorandum responds to your request for assistance dated May 21, 2002. This memorandum should not be cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUE

Exam has requested counsel advice as to whether an I.R.C. §338(g) election made by a purchasing corporation ("taxpayer") of a foreign target entitles the target to a step-up in basis allowing amortization of I.R.C. §197 assets, even when the foreign target is later domesticated.

CONCLUSION

In this case, the I.R.C. §338(g) election made by the taxpayer relating to the purchase of a foreign target entitles the target to a step-up in basis. As the foreign target is 100%

foreign-owned, holds no U.S. real property interests, is not engaged in U.S. business and does not hold assets that would produce U.S. income if sold, no U.S. tax consequences will result from either the stock sales or the target's deemed asset sales under I.R.C. §338. The result under I.R.C. §338 is not changed by the fact that the foreign target subsequently became a domestic entity. Therefore, the taxpayer should use the I.R.C. §338 stepped-up basis for amortization purposes.

FACTUAL SUMMARY

The facts, as we understand them, are as follows: The taxpayer, [redacted], is a domestic corporation within a consolidated group. On [redacted], the taxpayer purchased all of the stock of a foreign corporation (the "target") for $[redacted] and approximately $[redacted] of assumed liabilities. All of the former shareholders of the target were non-U.S. citizens. There are no facts that indicate that the target had any income that was effectively connected with the conduct of a U.S. trade or business. On [redacted], the foreign target became a domestic entity. On [redacted], the taxpayer filed a consolidated [redacted] Form 1120, which included the activities of the target for the period [redacted] to [redacted]. A copy of Form 8023-A dated [redacted] was included with the [redacted] Form 1120, which made an I.R.C. §338 election with respect to the assets of the target. Based on the I.R.C. §338 election, the target, which is now within the taxpayer's consolidated group, is claiming amortization of I.R.C. §197 intangibles (goodwill and technology) totaling approximately $[redacted] over a 15-year period.

LEGAL ANALYSIS

In general, I.R.C. §338 applies only to an electing corporate purchaser of at least 80% of the target corporation's stock within a twelve-month period (a "qualified stock purchase"). The code section treats the target as having sold all of its assets in a single transaction for their fair market value to a hypothetical new target corporation, which takes an aggregate basis in those assets in an amount generally equal to what the purchaser paid for the target corporation's stock. There is no requirement that the target corporation be liquidated. The target corporation recognizes gain or loss on

the deemed sale, just as it would on an actual sale of assets (the target corporation's shareholders recognize gain or loss on the sale of their target stock). The income from the deemed I.R.C. §338 sale is reported on the old target's tax return and may not be included in any consolidated return filed by the purchaser and its other subsidiaries. I.R.C. §338(h)(9). Thus, the §338 deemed sale of assets results in a full and immediate corporate level tax to the target corporation. This tax is generally borne by the purchasing corporation through its acquisition of the target (which is why, in the domestic context, few corporations make I.R.C. §338 elections).

Exam deems that it is inappropriate that the target should receive a step-up in basis allowing amortization of I.R.C. §197 intangibles under these circumstances. Exam believes that the purpose of I.R.C. §338 implies symmetrical tax consequences to the U.S.; that is, if the target gets the step-up in basis and resulting amortization expense on a U.S. consolidated return, then gain should also be recognized by the target in a manner that would have tax consequences within the U.S. The taxpayer, on the other hand, contends that the gain from the deemed sale of assets purchased, with respect to the I.R.C. §338 election, is to be recognized by the former shareholders of the target, rather than by the taxpayer. Exam has asked for advice on how I.R.C. §338 applies in situations involving foreign target corporations, which are then domesticated. Further, if the target should have recognized the gain prior to domestication, Exam has asked whether there would be dividend consequences to the taxpayer upon such domestication.

A qualified purchase of the stock of a foreign corporation that is not subject to U.S. tax on trade or business income creates one of the few cases where an affirmative election of I.R.C. §338 for the foreign target is advantageous (in order to get an inside step-up, purge the earnings and profits account, and any other unwanted tax attributes, without current U.S. tax cost). In general, foreign corporations are not subject to U.S. taxation on their worldwide income. Generally, foreign corporations are taxed on a net income basis at the same rates as a domestic corporation on income that is effectively connected (or treated as effectively connected) with a U.S. trade or business. See e.g. I.R.C. §§882(a) and 897. In addition, certain other U.S. source income of a foreign corporation that is not effectively connected with a U.S. trade or business is subject to tax on a gross basis at a rate of 30 percent. I.R.C.

§881(a). The rules governing the taxation of the foreign corporation may be altered if a tax treaty applies.

In the present case, assuming the taxpayer made a valid I.R.C. §338 election, the target would be treated as having sold all of its assets at the close of the acquisition date for their fair market value in a single transaction to a new corporation ("new target"). I.R.C. §338(a); Treas. Reg. §1.338-1(a). The old target would recognize gain or loss on the deemed sale, just as if it actually had sold its assets. I.R.C. §338(a), (b); Treas. Regs. §§1.338-1(a); 1.338-4. The income from the deemed I.R.C. §338 sale would be reported on the old target's foreign tax return. Treas. Regs. §§1.338-1(a)(3), 1.338-2(c)(10); 1.338-10. The tax would generally be borne by the U.S. taxpayer; however, in the case of a completely foreign-owned corporation, no U.S. tax consequences would result unless, as discussed above, it was engaged in a U.S. trade or business. Additionally, as a result of the I.R.C. §338 election, the new target would obtain a stepped-up basis in its assets equal to their fair market value. I.R.C. §338(a), (b); Treas. Regs. §§1.338-1(a); 1.338-5. Finally, we note that there are no facts which indicate that the taxpayer acquired an asset directly from the target (or target affiliate) during the consistency period (beginning one year prior to the qualified stock purchase and ending one year after the acquisition date). Thus, the asset acquisition consistency rules of I.R.C. §338(e) and would not apply and the taxpayer would not have to take a carryover (rather than cost) basis in the assets acquired.

Our office has discussed this issue with Christopher M. Bass (CC:CORP:B2), who agreed that, under the facts described above, the target would receive a step up in basis. Mr. Bass did not believe that the subsequent domestication of the foreign target would change this result. Our office also contacted Joseph M. Calianno (CC:INTL) for his interpretation of this situation. Mr. Calianno agreed with Mr. Bass's assessment, noting that the Regulations under I.R.C. §338 discussed certain post-acquisition events on eligibility for the I.R.C. §338 election and concluded that these events did not affect eligibility (see, e.g., Treas. Reg. §1.338-2(c)). In Mr. Calianno's opinion, domesticating the foreign target at a later date would not change the tax consequences of the initial I.R.C. §338(g) election.

On the other hand, if the foreign target has U.S. shareholders, or if the corporation has U.S. effectively connected business assets, U.S. tax consequences can arise on either the stock sale or the target's deemed-asset-sale transactions. Moreover, the foreign corporation may be subject to U.S. tax to the extent the deemed asset sale results in income effectively connected with a U.S. trade or business, income treated as effectively connected with a U.S. trade or business (e.g. deemed sale of U.S. real estate) or to the extent that the deemed sale results in U.S. source income that is taxable under I.R.C. §881. Finally, if the foreign target is a controlled foreign corporation, or CFC, (or if a foreign affiliate of a domestic target is a CFC), subpart F income and I.R.C. §1248 dividend consequences can arise from the I.R.C. §338 election.

As stated above, we are not aware of any facts that would indicate that the foreign target was a CFC or had U.S. effectively connected business assets when it was acquired by the taxpayer. However, once 100% of the foreign target was acquired by the taxpayer, it became a CFC. When the target corporation domesticated on [redacted], it created a transfer subject to I.R.C. §367(b). As a result of that transfer, a U.S. corporation owning shares of the domesticating corporation must include in its income its all earnings and profit amount. If the domestic corporation does not include this amount in gross income, for the purpose of determining the extent to which gain is recognized on the exchange, the foreign corporation will not be considered to be a corporation. However, the applicable provision of the Code other than §§354 or 356 shall apply as if the foreign corporation were considered a corporation. For example, I.R.C. §§ 358, 362 and 381m if applicable shall apply as if no gain had been recognized. Treas. Reg. §7.367(b)-7(c)(2) (as in effect in [redacted]). Should you require further advice as to these consequences, please contact our office.

A copy of this memorandum has been forwarded to our National Office to ensure that the above analysis is consistent with the National Office position. National office has agreed with our analysis and had suggested a few changes, all of which have been incorporated into the instant memorandum.

If you have any questions or concerns, please do not hesitate to contact the undersigned attorney at (408) 817-4694.

[redacted]
Associate Area Counsel
(Large and Mid-Size Business)

By: _____
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